



Urban & Labor Economics

The Role of The Urban Informal Sector in India's Economy

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Executive Summary

- Informal sectors, specifically urban informal sector, play significant roles in the economy and employment of the people in India.
- The dominance of the urban informal sector in India is mainly caused by urbanization coupled with premature deindustrialization.
- The urban informal sector has a significant role in income generation and unemployment reduction, leading to increased livelihood for the poor. On the other side, the urban informal sector faces challenges, such as low access to credit, production technologies, formal training, and public services.
- However, the existence of the urban informal sector still sparks debate on whether it is desired in the economy. The urban informal sector is typically characterized by low productivity, but its vital role as the livelihood of the urban poor and its potential resilience to shocks may benefit India's current economic condition if treated accordingly.
- It is acknowledged that the development of the urban formal sector can stabilize the urban informal sector through balanced transitions and increased productivity from the spillover effects.
- However, comprehensive policies targeted specifically to the urban informal sector are needed, including facilitation of capacity building, inclusive credit access, accommodative business insurance, and formalization mechanism that is adapted to specific informal sector types.

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Introduction

As was defined for India by the National Commission on Enterprises in the Unorganized Sector or NCEUS (2007), “the **informal sector** consists of all unincorporated private enterprises owned by individuals or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis and with less than ten total workers”.

Informal sectors play significant roles in the economy and employment of the people, specifically in developing nations such as India. In 2017, the informal sector contributed 43.1% to India’s total Gross Value Added (GVA) (Murthy, 2019). Moreover, employment in the informal sector accounted for 74.3% of total workers in India in 2022 (National Statistical Office, 2023b). This fact further signifies the pivotal role of the informal sector, especially if we consider the nature of the informal sector, such as lack of financial services and organized market, which make it relatively disadvantaged compared to the formal sector. Being able to thrive despite those limitations illustrates the survivability of the informal sector. However, the state of the informal sector also brought concerns on its own. Therefore, understanding the nature and significance of the informal sector in India may provide insights into the most suitable policy framework to support its role and address its challenges.

The urban informal sector is an essential part of India’s economy. As was asserted by Harris & Todaro (1970), the informal sector emerged due to the transition of a rural underdeveloped economy to a modern urban economy (Todaro & Smith, 2015). This means that the urban informal sector is a key component of India which is currently undergoing urban development. Since 1970, the share of the population living in urban areas has increased from 20% to 36% in 2022. Although this number is still below that of the urban growth in other emerging countries, such as Indonesia and China, the relatively late yet steady urbanization can almost be said as a certain phenomenon that will cause further urban informal sector growth in India.

Despite the potential of the urban informal sector to assist the urban economy, improving their conditions is not a simple task. According to Admasu et al. (2019), the informal sector in urban areas has a significant role in income generation and unemployment reduction, leading to increased livelihood for the poor. Moreover, as jobs in the urban informal sector typically are in the form of small sellers (e.g. hawkers, street food vendors, etc) and service workers (e.g. repair works, housekeeping, etc), this sector can be an important provider of basic goods and services to consumers, especially for low-income populations (Asmamaw, 2014, as cited in Lorato et al., 2023). It is therefore really unfortunate that the urban informal sector faces challenges, such as low access to credit, production technologies, formal training, and public services (ILO, 2015).

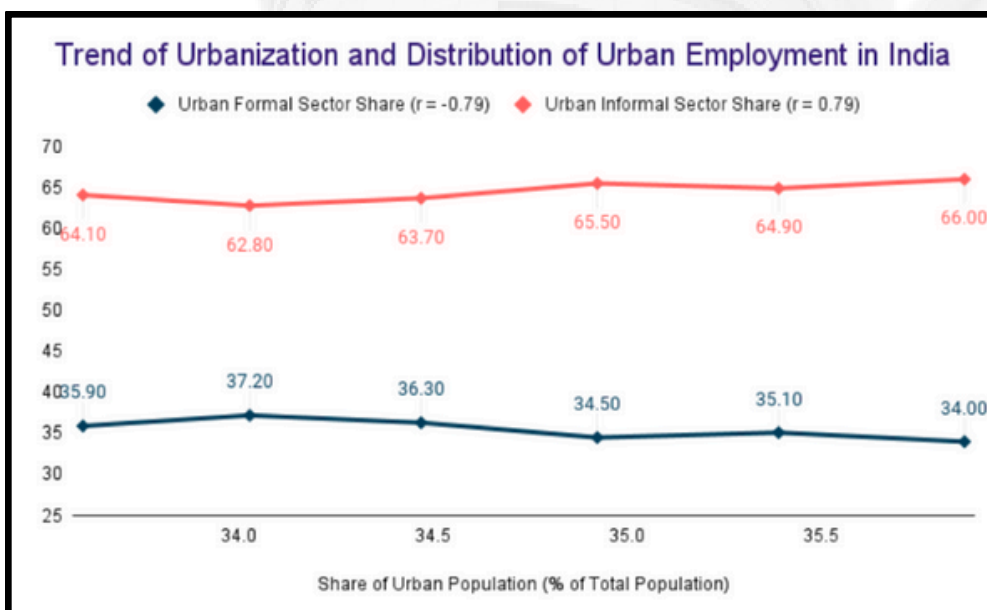


However, the existence of the urban informal sector still sparks debate on whether it is desired in the economy (Todaro & Smith, 2015). Although several studies have pointed out the contributions of the urban informal sector, it is in India's best interest to assess the role of the urban informal sector in its economy, especially considering the vast variation of social and demographic conditions in developing countries. Therefore, this Microeconomics Dashboard's special edition study aims to review the role of the urban informal sector in India's urban economy and the suitable policy direction to address the urban informal sector in India.

The Characteristics and Role of India's Urban Informal Sector

Urbanization is generally associated with economic growth that causes structural transitions towards the urban formal sector, although this is not always true. In India, as is shown in Figure 1, employment in the urban informal sector grows as the share of the urban population increases. Yuki (2017) argues that urbanization without industrial growth may explain the case of urban informal sector expansion. This argument may be valid for India, given that in the last decade, the contributions of manufacturing to the Gross Domestic Product (GDP) have been declining (Djidonou & Foster, 2022). This implies that the growth of the urban informal sector may be the side effect of stagnating industrialization. However, the potential of reverse causality between the urban informal sector and urbanization must be carefully considered. As highlighted by Todaro & Smith (2015), increasing income and employment opportunities in the urban informal sector may also result in more rural-urban migration. Although this argument seems less likely in India's case currently, the idea itself will hold significant importance in the policy design of India's urban informal sector.

Figure 1. The Trend of Urban Informal and Formal Sector Employment Share in India

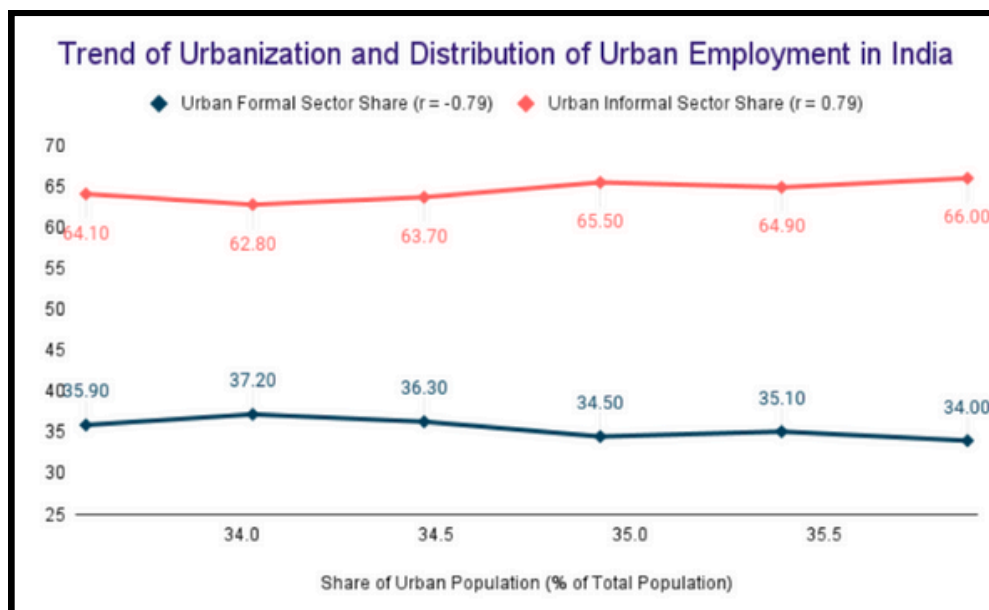


Source: National Statistical Office (2019, 2020, 2021, 2022, 2023, 2023b) & World Bank (2024). Author's estimation.



As an economy with small-scale production and limited resources, the informal sector is often considered to be vulnerable to economic shocks (ADB, 2011). However, Figure 2 shows different perspectives, where the share of employment in the urban informal sector increases despite the fall in urban employment to population ratio. This trend indicates two possibilities. First, there is a shift of workers from the urban formal sector to the urban informal sector as a consequence of contracting labor market. Due to the difficulty of attaining jobs after being laid off, people might choose to work in the informal sector that is not significantly affected by the COVID-19 restrictions, such as informal e-commerce (Ridhwan et al., 2021; Sawada et al., 2023). Other than that, there is an increase in women's participation in the labor market as informal sector workers due to a decrease in household income (Todaro & Smith, 2015). Second, the urban informal sector may be relatively resilient to the pandemic shock compared to the urban formal sector. The informal sector which has low capital requirements will have greater flexibility in conducting economic activities, and thus also has better chances to survive and restore productivity (Pitoyo et al., 2020).

Figure 2. The Resilience of the Urban Informal Sector during COVID-19 in India

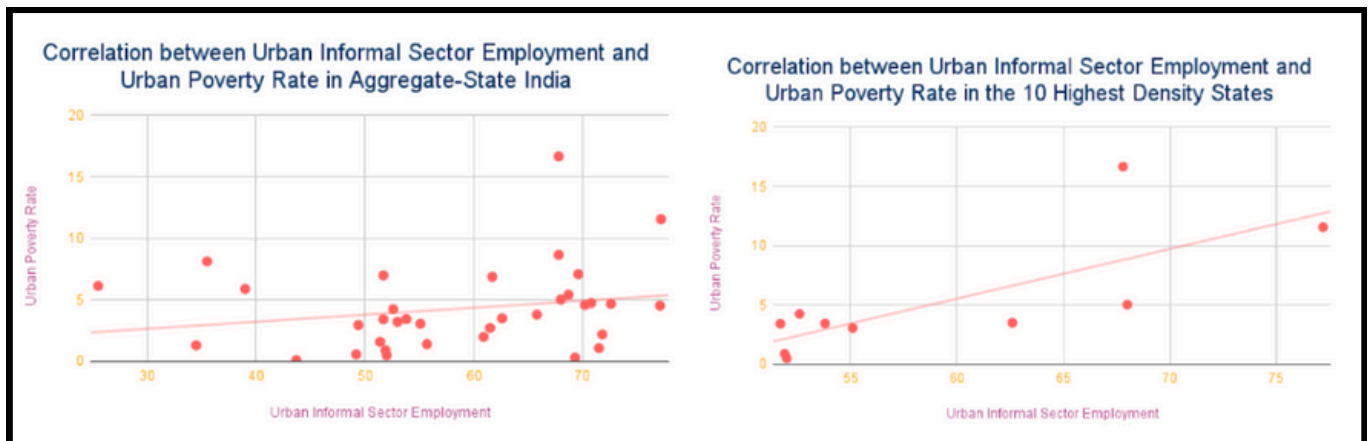


Source: National Statistical Office (2019, 2020, 2021, 2022, 2023, 2023b) & ILOSTAT (2024).

Many studies have observed that a substantial proportion of the urban poor work in the urban informal sector (ILO, 2023; Kar & Marjit, 2009). Not only that, the informal sector is said to absorb a huge workforce that is unable to be hired in the formal sector as a consequence of rapid urbanization, thus having an important role in poverty alleviation (United Nations, 1995). However, cross-sectional data analysis of 36 Indian states in 2019 shows that there is no strong correlation between poverty rate and share of employment in the urban informal sector, with Pearson correlation coefficient numbering at only 0.16. On the other hand, the correlation in the ten highest population density states appears to be higher ($r = 0.42$), although by no means illustrates a strong association.



Figure 3. Relationship between Share of Urban Informal Sector Employment and Urban Poverty Rate in India



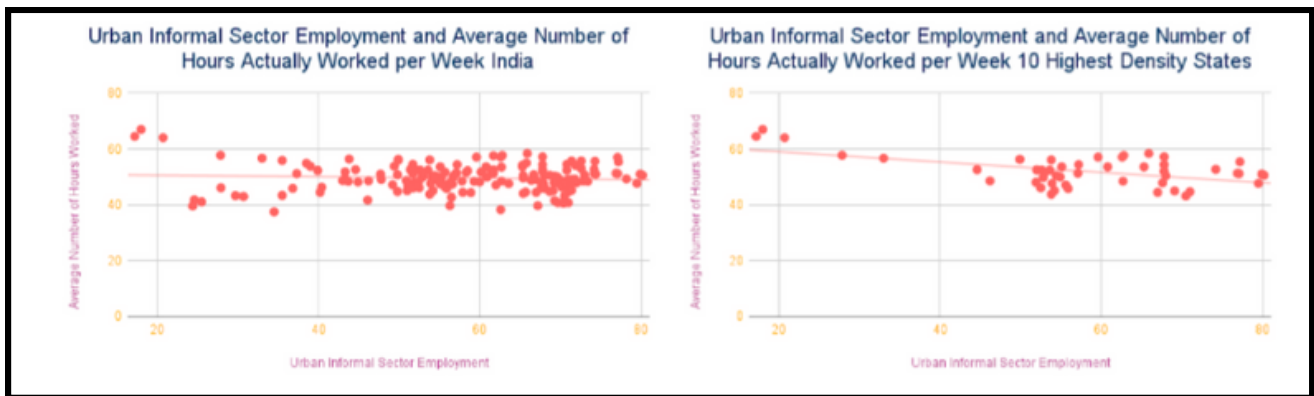
Source: National Statistical Office (2019, 2020, 2021, 2022, 2023, 2023b) & NITI Aayog (2023). Author's estimation.

This brings us to a more nuanced discussion of the relationship between the urban informal sector and the urban poverty rate. On one hand, the urban informal sector can help reduce urban poverty by providing a way of livelihood for the urban poor who otherwise might be unemployed, thus emphasizing the negative correlation between the two variables. On the other hand, an increase in the number of urban poor may also result in a higher share of urban informal sector employment, as it is typically their main source of income. Although, in a way, this also implies that the urban informal sector has failed to serve as a tool for poverty reduction.

Reflecting on that, the complexity of the relationship between the urban informal sector and poverty may be the reason for the indefinite conclusion that we observe from the data. However, as insignificant as it may seem, the positive correlation observed from the graph may imply that the relationship between the urban informal sector and urban poverty in India is closer to the latter argument. The poor's limited choice forces them to work in the informal sector and workers in this sector typically earn less than those in the formal sector. As was asserted by Smolka in the report by the Asian Development Bank (2014, p. 18), "Contrary to popular beliefs, informality is expensive and therefore is not the best or even an advantageous alternative to combating poverty, but it is usually the only one available to the urban poor".



Figure 4. The Relationship between Share of Urban Informal Sector Employment and Urban Average Working Hours in India



Source: National Statistical Office (2019, 2020, 2021, 2022, 2023, 2023b). Author's estimation.

One main concern about the dominance of the urban informal sector is that it costs the economy. A rise in the employment share of the urban informal sector may shift the available labor force from the more productive formal sector, resulting in lower economic growth (Djidonou & Foster, 2022). Moreover, to pursue the same level of earnings as in the formal sector, workers in the urban informal sector with lower productivity tend to work longer hours (ILO, 2013).

This study tried to estimate the correlation between the share of urban informal sector employment and hours of work in India. Utilizing the pooled cross-sectional data from 2018 – 2022, the result shows that there is no correlation between the share of urban informal sector employment and hours of work in India (see Figure 4). Even though data from the ten highest density states indicate a higher correlation (with coefficient of correlation (r) = -0.52), the pooled Ordinary Least Squares (OLS) and random effects regression results also indicate that there is no significant effect of urban informal sector employment on hours of work (see Table 1). Instead, earnings of regular salaried employment have a negative significant effect on average working hours. However, endogeneity could be a potential issue in these simple estimations, and thus careful evaluation should be undertaken.



Table 1. The Impact of Share of Urban Informal Sector Employment and Earnings on Working Hours in Urban India

	Natural Log Urban Average Number of Hours Actually Worked per Week	
	Pooled OLS	Random Effects
Share of urban informal sector employment	-0.00101 (-1.00)	-0.00137 (-0.55)
Natural log urban earnings of regular salaried employment	-0.262** (-3.16)	-0.120** (-2.34)
Natural log urban earnings of self-employment	0.201* (2.05)	0.0516 (0.71)
Covid-19 pandemic	0.0267 (1.27)	0.0139 (0.93)
Constant	4.625*** (6.05)	4.706*** (8.82)
Observations	50	50

Note: *, **, and *** show significance at 10%, 5%, and 1% respectively. Earnings of regular salaried employment are calculated monthly, while earnings of self-employment is calculated in a 30-day period. The data are compiled from India's Periodic Labor Force Survey (PLFS) 2017 - 2022. Random effects was chosen from Chow, Hausman, and Breusch-Pagan tests. No heteroskedasticity was found and both regressions used clustered standard errors to solve for serial correlation problems.

Nonetheless, the above results imply a possibility that despite the lower earnings, workers in the Indian urban informal sector choose to work the same hours as the formal sector workers. This result makes sense if we consider that one of the main motivations for employment in the informal sector is to earn enough income for basic survival (Todaro & Smith, 2015). A relatively similar working hours despite lower earnings may present a concern, given that lower wages in the informal sector is associated with a higher incidence of urban poverty (Kar & Marjit, 2009). However, this does not mean that encouraging higher working hours for the urban informal sector would be an ideal solution. Instead, improving the productivity and efficiency of the urban informal sector would be a more suitable approach, as it will increase income for the urban informal sector workers.



Discussion and Recommendations

From the above discussions, it is known that the urban informal sector is a side effect of urbanization which is coupled with stagnation in the industry sector. Then, if the urban informal sector is merely a byproduct of premature deindustrialization, is the existence of this sector unwanted, and thus its growth must be suppressed? The answer is: that is not necessarily true. From our findings, it is observed that the urban informal sector is the livelihood of the urban poor. Moreover, this sector shows potential resilience to shock and plays a significant role as an absorber of the unutilized urban labor. However, limitations of the urban informal sector including its low productivity and effectiveness in poverty reduction may pose a huge challenge to India's labor market policy.

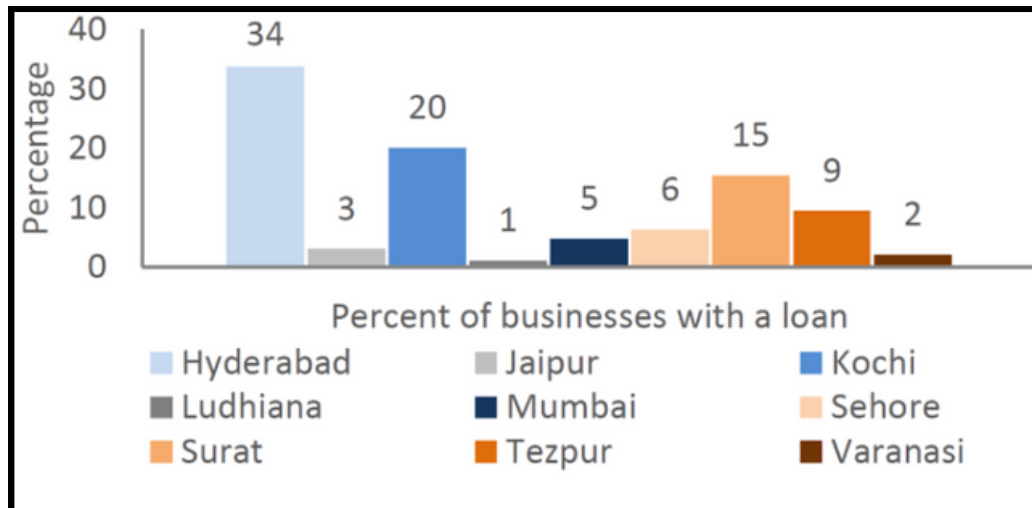
Nonetheless, it needs to be acknowledged that the growth in the urban modern (formal) sector is beneficial to the country, thus strategy towards better industrial development is of importance. Not only in the sense of overall economic growth, tackling industrialization may also result in the stabilization of the urban informal sector growth, as failing industrial development is the core cause of the informal sector boom. Moreover, the growth of the formal industrial sector may increase the productivity of the urban informal sector, especially in manufacturing (Djidonou & Foster, 2022). Yet, it does not imply a complete disregard for the urban informal sector. The existence of the urban informal sector could benefit India if treated correctly.

Policies geared towards improving the skills and capacities of the urban informal sector to engage in more productive economic activities are one of the main keys (ADB, 2011). Sodhi & Wessels (2016) highlighted that, despite skill development programs provided by India's government, 95.4% of women and 91% of men working in the informal sector still have not received vocational training. High opportunity costs and low financial resources often make it difficult for businesses in the urban informal sector to acquire skills. Hence, facilitating technical training and provision of its information through local authorities may be greatly effective (USAID, 2023). As the urban informal sector is typically characterized by low productivity, an increase in their production capabilities will benefit not only the aggregate economy but also the urban poor who rely their livelihood on the informal sector.

On the other hand, ensuring inclusive credit access and business insurance that are specifically targeted to the urban informal sector can support them in scaling up their businesses (Baruah, 2021). Due to its nature of informality, obtaining suitable financing for informal business is quite difficult. Figure 5 shows that, in 6 out of 9 cities, the proportions of informal businesses with a loan are merely below 10%, with some even ranging around 1–3%. Thus, lower credit requirements for specific financing schemes to the urban informal sector can open more opportunities. Coordination from local authorities to potential finance providers, such as community banks and microfinance institutions, becomes crucial to ensure effective provisions of funding. In addition, ensuring access to business insurance is important because risk mitigation could encourage urban informal businesses to adopt technologies and innovations. De Beer & Wunsch (2016) asserted that threats to health, safety, and other such risks are critical barriers to innovations in the informal sector.



Figure 5. Share of Informal Sector Business with a Loan in 9 Cities in India, 2022



Source: World Bank Group (2022).

Lastly, the formalization of the urban informal sector should be approached carefully and adapted to the specific needs of the informal sector type. As was discussed earlier, improvement in the conditions and employment opportunities in the urban informal sector may result in a more rapid urbanization. This will put more pressure on the urban formal and informal sector to absorb the increasing labor force, leading to potentially worse urban unemployment (Todaro & Smith, 2015). Therefore, transitioning the informal sector into the formal sector is important to limit the unnecessary incentive for rural-urban migration. One important consideration is that different groups of the informal sector may have different needs for formalization, such as licenses to sell and access to public space for street vendors, while decent working conditions and benefits for domestic workers. Designing a suitable formalization mechanism through the use of incentives and proper regulation is also one of the most important steps. However, it must be noted that formalization alone may not be enough to improve the welfare of the poor workers in the urban informal sector (OECD & ILO, 2019). Hence, alongside the transitioning process into the formal sector, the provision of social protection schemes through health coverage, safety nets, and pension programs is also equally crucial, in order to reduce the vulnerability of the urban poor in the informal sector.



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